

# PERESTROYKA AND WESTERN DIRECT INVESTMENT: THE TASK OF INTEGRATING A WESTERN COMPANY INTO THE CHANGING SOVIET ECONOMY

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## 1. INTRODUCTION

Under President Mikhail Gorbachev's policy of *perestroyka*, or restructuring, the Soviet government has decided to allow foreign investment in the Soviet economy. Western investors may now establish investments under the 1987 Joint Venture Decree<sup>1</sup> or the 1990 Regulation on Joint-Stock Companies and Limited Liability Companies.<sup>2</sup> For most companies organized under these laws, success or failure will depend upon the ability of economic reforms to transform the Soviet economy into a market economy and integrate it into the world economy.<sup>3</sup> Westerners seeking to invest in the Soviet Union must accept that they are gambling on the eventual success of market reforms which will span a generation.<sup>4</sup>

The performance of Western investment in the Soviet Union has thus far been something short of spectacular. The Soviet government estimates that up to seventy percent of joint ventures between Western

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<sup>1</sup> On the Establishment in the Territory of the USSR and Operation of Joint Ventures with the Participation of Soviet Organizations and Firms from Capitalist and Developing Countries, 1987 *Sobranie Postanovlenii i Pravitelstva SSSR* [SP SSSR] No. 9, item 40 (Decree of the USSR Council of Ministers of Jan. 13, 1987), *translated in* K. HOBER, *JOINT VENTURES IN THE SOVIET UNION* app. 3 (1989) [hereinafter *Joint Venture Decree*].

<sup>2</sup> Regulation on Joint-Stock Companies and Limited Liability Companies, 1990 SP SSSR No. 15, item 82 (Decree of the USSR Council of Ministers of June 15, 1990), *translated in* USSR LEGAL MATERIALS (V. Pechota & P. Pettibone eds. 1990) [hereinafter *Regulation on Joint-Stock Companies*].

<sup>3</sup> *Russian Roulette with Six Bullets*, *ECONOMIST*, Jan. 12, 1991, at 64-65 [hereinafter *Russian Roulette*]. See generally Osakwe, *The Death of Ideology in Soviet Foreign Investment Policy: A Clinical Examination of the Soviet Joint Venture Law of 1987*, 22 *VAND. J. TRANSNAT'L L.* 1 (1989).

<sup>4</sup> Hertzfeld, *Joint Ventures: Saving the Soviets from Perestroika*, *HARV. BUS. REV.* Jan.-Feb. 1991, at 80, 81.

companies and Soviet firms will fail.<sup>5</sup> Official statistics that list 2,800 joint ventures registered with Soviet authorities are somewhat misleading.<sup>6</sup> In reality, fewer than 1,000 of these joint ventures actually have bank accounts<sup>7</sup> and only a small number of these are operating, profitable ventures.<sup>8</sup> The majority of joint ventures are either fronts for Soviet cooperatives that seek the tax benefits conferred on the joint venture form<sup>9</sup> or thinly capitalized brokerages for Western exporters that do not manufacture anything in the Soviet Union.<sup>10</sup> Many other joint ventures exist on paper only.<sup>11</sup> The few hundred joint ventures that have successfully established manufacturing operations are grinding to a halt.<sup>12</sup> Soviet customers that promised to pay joint ventures in hard currency have not been able to pay their bills.<sup>13</sup> Moreover, these domestic hard currency transactions are the exception; in order to earn hard currency, most joint ventures must still conduct export transactions<sup>14</sup> under a strictly controlled export regime.<sup>15</sup>

The Soviet political situation is unclear,<sup>16</sup> and it is likely that the environment for investment will remain uncertain for some time.<sup>17</sup> Nevertheless, many Western business leaders have decided that the problems of doing business in the Soviet Union are more than offset by the opportunities presented there.<sup>18</sup> Some Western businesspersons agree that sound reasons exist for investing now, rather than waiting

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<sup>5</sup> Failure Rate for Western Joint Ventures in Soviet Union Seen Hitting 70 Percent, 6 Int'l Trade Rep. (BNA) 1603 (Dec. 6, 1989) [hereinafter Failure Rate].

<sup>6</sup> *Russian Roulette*, *supra* note 3, at 65.

<sup>7</sup> *Id.*

<sup>8</sup> See U.S. Firms Operating in Soviet Union Face 'Enormous' Problems, Expert Says, 6 Int'l Trade Rep. (BNA) 1484 (Nov. 15, 1989).

<sup>9</sup> *Russian Roulette*, *supra* note 3, at 65.

<sup>10</sup> *Id.* The capital structure for this type of brokerage or intermediary was outlawed in December 1988. However, a "grandfather clause" permits joint ventures registered before March 1989 to import goods manufactured outside the Soviet Union. See *infra* notes 122-34 and accompanying text.

<sup>11</sup> *Russian Roulette*, *supra* note 3, at 65.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> See *infra* notes 113-34 and accompanying text.

<sup>16</sup> Schmemann, *A Gain for Yeltsin: Marchers Face Kremlin's Huge Show of Force without Violence*, N.Y. Times, Mar. 29, 1991, at A1, col.6.

<sup>17</sup> Hertzfeld, *supra* note 4, at 84.

<sup>18</sup> Commerce's Willkie Discusses Administration Efforts to Assist Reform in Eastern Europe, 7 Int'l Trade Rep. (BNA) 1308, 1309 (Aug. 22, 1990). See Hertzfeld, *supra* note 4, at 80.

The Soviet Union offers Western investors the chance to reach a potential market of over 280 million consumers. HOBBS, *supra* note 1, at IX.G(1). The potential for profit is enormous, especially in Russia, the Ukraine, and the Baltic Republics, where there are tens of millions of cultured, educated, and motivated Europeans who need virtually everything. Hertzfeld, *supra* note 4, at 84.

for more economic stability in the future.<sup>19</sup> Although conditions may be more predictable in several years, individuals investing sooner will have established an advantageous infrastructure with Soviet consumers and Soviet partners.<sup>20</sup> The decision to invest now with the proper strategy could create a significant competitive advantage.<sup>21</sup>

For now, and for at least the next several years, Western enterprises investing in the Soviet Union must attempt to create their own markets within an economy that remains largely subject to central planning, with virtual or complete government monopolies on currency, foreign exchange, and foreign trade. In order to survive in this environment, Western investors must tailor their businesses to operate within the constraints of this economic system and prepare for the economic turmoil that anticipated reforms are likely to produce.

During the next ten years, successful investment in the Soviet Union will require a high degree of operational self-sufficiency within the Soviet economy.<sup>22</sup> This article discusses the Soviet system of central economic planning and analyzes the ways in which it complicates the task of integrating Western concerns into the Soviet economy. Economic reforms over the past two years have allowed for a significant amount of decentralization. However, with these reforms have come new inefficiencies as Soviet producers have engaged in hoarding and other autarkic behavior. Rather than creating efficient markets, these reforms appear to have compounded the problem of obtaining reliable market information. Western investors must continue to rely upon personal connections to obtain the supplies and services necessary to conduct business operations.

The article will then consider the Soviet monetary system and describe the ways in which Western investors are affected by Soviet monetary policy. The Soviet system of administratively set prices is a fundamental element of Soviet economic ideology. Price controls are troublesome to Western investors because they distort the value of the ruble in the domestic economy, prevent the formation of efficient markets, and conceal the effects of inflation in the Soviet Union. It is the system of price controls that creates the necessity for the government monopoly on foreign exchange. In turn, the Soviet exchange controls, which render the ruble completely worthless outside the Soviet Union, remain the most problematic aspect of investment in the Soviet Union.<sup>23</sup>

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<sup>19</sup> Hertzfeld, *supra* note 4, at 84.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 81.

<sup>23</sup> *Id.* at 82.

Exchange controls cause problems for Western investors from the very outset of a business venture. The Joint Venture Decree incorporates the official rate of exchange into its valuation provisions. These provisions create difficult questions of valuation when Western investors bring their initial capital contribution into the Soviet Union. This article will discuss some strategies for negotiating around the problem of valuation. Until the ruble becomes freely convertible, Western investors will have to earn hard currency in one of three ways: a new system of hard currency auctions, domestic hard currency transactions, or export transactions.

In the fall of 1990, the Soviet government proposed a system of special hard currency auctions to be open as of January 1, 1991.<sup>24</sup> The system has yet to be implemented, but it is certain that the rate of exchange will be very high.<sup>25</sup> Unpredictability regarding the rate of exchange and uncertainty as to the amount of hard currency that will be for sale will subject every Western concern relying on these auctions to a high degree of transaction exposure.<sup>26</sup> Any profit in rubles could easily be erased by exchange losses.<sup>27</sup>

Another method of earning hard currency in the Soviet Union is to negotiate transactions with Soviet parties who are willing and able to pay in hard currency.<sup>28</sup> However, the current problem of delayed payments is indicative of the limited possibilities for such transactions.<sup>29</sup> Too little hard currency is available, and those who possess it are generally unwilling to part with it.<sup>30</sup>

Most joint ventures must follow the third option and engage in export transactions in order to earn hard currency.<sup>31</sup> During the first two years following the enactment of the Joint Venture Decree, many

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<sup>24</sup> Decree of the USSR President on the Introduction of the Commercial Rate of the Ruble Against Foreign Currencies and on Measures to Create an All-Union Hard Currency Market, *reprinted in* *Izvestiya*, Oct. 26, 1990, *translated in* *Federal News Service*, Oct. 26, 1990 (LEXIS, NEXIS library, Wires file) [hereinafter *Hard Currency Market Decree*].

<sup>25</sup> Keller, *Soviets to Let West Convert Ruble Profits*, *N.Y. Times*, Oct. 30, 1990, at D1, col. 6, D25, col. 5 [hereinafter Keller, *Ruble Profits*].

<sup>26</sup> See J. BLIN, S. GREENBAUM & D. JACOBS, *FLEXIBLE EXCHANGE RATES AND INTERNATIONAL BUSINESS* 28-30 (1981) [hereinafter *FLEXIBLE EXCHANGE RATES*].

<sup>27</sup> U.S., *Soviet Economists Consider Plan to Make Ruble Convertible by Year 2005*, 6 *Int'l Trade Rep.* (BNA) 1315 (Oct. 11, 1989).

<sup>28</sup> On Additional Measures to Improve the Country's External Economic Activity in the New Conditions of Economic Management (Decision of the CPSU Central Committee and the USSR Council of Ministers of Sept. 17, 1987), *reprinted in* *ECONOMICHESSKAYA GAZETA*, Oct. 1987, *translated in* *HOBER*, *supra* note 1, at app. 4(6) [hereinafter *External Economic Activity Measures*].

<sup>29</sup> *Russian Roulette*, *supra* note 3, at 65.

<sup>30</sup> See *HOBER*, *supra* note 1, at IX:G(1).

<sup>31</sup> *Russian Roulette*, *supra* note 3, at 65.

joint ventures were organized as thinly capitalized brokerages, designed to purchase Soviet products for resale on world markets for hard currency.<sup>32</sup> However, in March, 1989, the Soviet government issued a decree which restricts the possibilities for generating hard currency in this manner.<sup>33</sup> This decree limits joint ventures to exporting only those goods that they have manufactured and importing only those goods necessary for their own production. Because of this bureaucratic control over foreign trade joint ventures can no longer export countertrade goods. In order to earn hard currency on export markets, joint ventures must now manufacture their own goods in the Soviet Union.

Over the next two years, the Soviet government plans to implement a program of currency reforms that will gradually free the prices of certain commodities.<sup>34</sup> As the Soviet Union removes controls on the procurement prices that the government pays to Soviet producers, the producers will be able to demand higher prices for the products that they sell to joint ventures.<sup>35</sup> Every joint venture making purchases of inputs will be subject to economic exposure as price controls at the production level are freed.<sup>36</sup> Furthermore, the intentionally vague schedule of price reforms described in President Gorbachev's economic program will cause other problems for Western concerns. This schedule is designed to counter strategic behavior on the part of Soviet producers. Past experience has shown that advance notice of price reforms creates a "domino effect."<sup>37</sup> When Soviet producers receive advance notice, they hold their goods off the market until the price increase goes into effect. The policy of no advance notice will defeat this strategic behavior. However, this policy will create planning problems for Western concerns, by making it very difficult to predict the availability and cost of necessary supplies. Therefore, Western enterprises should consider the advantages of entering into relational contracts to reduce economic exposure caused by President Gorbachev's program of price reforms.

This article will conclude by assessing the long-term potential for Western investment in the Soviet Union under the current pace of

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<sup>32</sup> Hertzfeld, *supra* note 4, at 86.

<sup>33</sup> On Measures for Regulation of Foreign Economic Activities, 1989 SP SSSR No. 16, item 50 (Decree of USSR Council of Ministers of Mar. 7, 1989), *translated in* HOBES, *supra* note 1, at app. 22 [hereinafter Regulation of Foreign Economic Activities].

<sup>34</sup> Keller, *Gorbachev Offers His Plan to Remake Soviet Economy, But Includes No Timetable*, N.Y. Times, Oct. 17, 1990, at A1, col. 6, A8, col. 3 [hereinafter Keller, *Soviet Economy*].

<sup>35</sup> Keller, *Malevolent Boomerang Rules Soviet Economy*, N.Y. Times, Oct. 22, 1990, at A6, col. 1 [hereinafter Keller, *Boomerang*].

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

reform.

Most of the analysis in this article will focus on investments established under the 1987 Joint Venture Decree. The Joint Venture Decree was the first of Gorbachev's economic reforms allowing foreign investment, and the joint venture form remains the most common type of foreign investment in the Soviet Union. The Regulation on Joint-Stock Companies is new in comparison, and there has been little experience in its practical operation. In spite of some major differences between these two forms of investment, most of the economic analysis in this article will apply to investments organized under either decree. Where necessary, this article will make clear the distinctions that apply to these different forms of investment.

## 2. CHANGES IN THE SOVIET SYSTEM OF CENTRAL ECONOMIC PLANNING

For the great majority of Western companies coming to the Soviet Union, the key to a successful investment strategy will be to achieve a high degree of operational self-sufficiency within the Soviet economy.<sup>38</sup> Vertical integration within the Soviet economy will limit dependence on world suppliers, and thus minimize the expenditure of hard currency.

Shortly after enactment of the Joint Venture Decree, Western business leaders recognized that the most daunting obstacles to the profitability of any type of Western investment would be the problems associated with integration into the Soviet economy.<sup>39</sup> In theory, joint ventures were to be exempt from the government's economic plan and administrative price controls.<sup>40</sup> However, in practice, joint ventures had to rely upon government entities that were subject to such bureaucratic controls.<sup>41</sup> Locating and gaining access to supplies and raw materials in the centrally controlled distribution system was often very difficult.<sup>42</sup>

Recent economic reforms have resulted in a significant degree of decentralization, but rather than easing the problems of integration, these reforms appear to have compounded them. Over the last three years, the Soviet government has enacted decrees providing for the res-

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<sup>38</sup> Hertzfeld, *supra* note 4, at 81.

<sup>39</sup> Recent Development, *Foreign Investment: New Soviet Joint Venture Law*, 28 HARV. INT'L L.J. 473, 477 (1987).

<sup>40</sup> See Joint Venture Decree, *supra* note 1, at art. 23 (stating that the Soviet government "shall not establish binding planning tasks" nor guarantee a market for a joint venture's products).

<sup>41</sup> W. Surrey & V. Lechtman, *New Soviet Joint Venture Law: A Political Curiosity or a Real Investment Opportunity?*, PRIVATE INVESTORS ABROAD - PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1988, at 6-1, 6-9 (1989).

<sup>42</sup> Failure Rate, *supra* note 5, at 1604.

toration of some private property rights, as well as expanded possibilities for private entrepreneurship.<sup>43</sup> New economic laws have authorized the small-scale production of consumer goods and services, and granted substantial economic freedom for privately owned cooperatives.<sup>44</sup> In the summer of 1990, the Supreme Soviet enacted the Law on Enterprises, which contemplated new freedoms from the control of central planning.<sup>45</sup> The Law on Enterprises described an operating environment in which firms would determine their own output on the basis of demand, obtain inputs on the basis of market purchases, negotiate credit terms with suppliers, and set prices for their outputs on the basis of negotiated sales contracts.<sup>46</sup> However, this law also contained an important provision in which the state reserved the right to set contracts with enterprises and to determine prices where enterprises have monopolies over certain sectors of the economy.<sup>47</sup> Since monopoly relationships predominate in the Soviet Union, this provision effectively preserves centralized control over a large part of the Soviet economy.<sup>48</sup>

Approximately eighty percent of production in the Soviet economy currently remains under central planning.<sup>49</sup> Additionally, one proposed decree demands that all enterprises supply the centralized trading system first.<sup>50</sup> If implemented, this decree would reinforce pervasive central planning in the Soviet economy.<sup>51</sup>

The overall effect of these reforms has been a general collapse in centralized control of the Soviet economy.<sup>52</sup> The system of centralized allocation and distribution has broken down and the government has not been successful in creating markets to replace the old system.<sup>53</sup> Rather than behaving as profit maximizers, Soviet firms are engaging in autarkic behavior, such as hoarding and producing goods which

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<sup>43</sup> See Stephan, *Perestroika and Property: The Law of Ownership in the Post-Socialist Soviet Union*, 39 AM. J. COMP. L. 35, 48-59 (1991) [hereinafter Stephan, *Perestroika and Property*].

<sup>44</sup> *Id.*

<sup>45</sup> Law on Enterprises in the USSR, 1990 Vedomosti Verkhovnoy Soveta SSSR [Ved. Verkh. Sov. SSSR] No. 25, item 460 (Edict of the Presidium of the Supreme Soviet of the USSR of June 4, 1990), translated in USSR LEGAL MATERIALS (V. Pechota & P. Pettibone eds. 1990) [hereinafter Law on Enterprises].

<sup>46</sup> See Stephan, *Perestroika and Property*, *supra* note 43, at 60; Law on Enterprises, *supra* note 45, at arts. 23(1), 24, 25(1), 26(1), 27(5).

<sup>47</sup> Law on Enterprises, *supra* note 45, at arts. 23(2), 26(2).

<sup>48</sup> Stephan, *Perestroika and Property*, *supra* note 43, at 60.

<sup>49</sup> Hertzfeld, *supra* note 4, at 89.

<sup>50</sup> *Russian Roulette*, *supra* note 3, at 65.

<sup>51</sup> *Id.*

<sup>52</sup> Stephan, *The Restructuring of Soviet Commercial Law and Its Impact on International Business Transactions*, 24 GEO. WASH. J. INT'L L. & ECON. 89, 97 (1991) [hereinafter Stephan, *Restructuring of Soviet Commercial Law*].

<sup>53</sup> *Id.* at 98.

make economic sense only within the context of the bureaucratic system upon which they depend for their own supply needs.<sup>54</sup> The resulting misallocation of resources, shortages, and diversion of goods to the black market are antithetical to the interests of Western companies that seek to establish rational markets based upon supply and demand. The recent trend toward entropy intensifies the information problem that faces Western companies as they seek to integrate their business into the Soviet economy. In this distorted environment, the personal connections of Soviet partners will be placed at a premium.

### 3. PRICE CONTROLS: THE STATE MONOPOLY ON CURRENCY

In a planned economy there is a fundamental conflict between maintaining political control over economic decisions and having a system of currency which stands as a reliable store of value.<sup>55</sup> Policymakers in the Soviet Union have historically preferred political control over a rational system of currency valuation. In fact, the original ideologues of Soviet communism believed that their economy would work without the need for currency.<sup>56</sup> Since the beginning then, currency in the Soviet economy has been used by the government as a tool of political control.

The necessity of strict government control over currency is an integral part of the economic ideology developed under Stalin. The Stalinist economy was based upon four fundamental elements: state ownership of the means of production, fixed prices bearing no relation to market forces, enterprise performance evaluated in terms of gross quantitative output targets, and a centralized hierarchical administrative apparatus.<sup>57</sup> Because the state owns the means of production, there are no markets which might set prices. Without markets to set prices, profit is a useless criterion for evaluating performance. Therefore, it becomes necessary to impose quantitative criteria through a central administrative apparatus to prevent managers from producing goods for which the state pays the highest price.<sup>58</sup>

Until last year, the Soviet government employed a comprehensive system of administrative regulations that set all prices from the produc-

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<sup>54</sup> Stephan, *Perestroika and Property*, *supra* note 43, at 61.

<sup>55</sup> See M. LINDSAY, *INTERNATIONAL BUSINESS IN GORBACHEV'S SOVIET UNION* 193 (1989).

<sup>56</sup> A. ZWASS, *MONETARY COOPERATION BETWEEN EAST & WEST* 2 (1975).

<sup>57</sup> STEPHAN, *SOVIET ECONOMIC LAW: THE PARADOX OF PERESTROYKA* 7 (The Carl Beck Papers in Russian and East European Studies No. 805, 1990) [hereinafter STEPHAN, *PARADOX OF PERESTROYKA*].

<sup>58</sup> *Id.*



tion level<sup>59</sup> to the retail level.<sup>60</sup> Comprehensive price controls enabled the government to override the market forces of supply and demand and replace them with centrally preferred levels of production. Because administratively set prices bore no relationship to market forces, no benefit was gained from comparing the cost of raw materials with the total proceeds from sales.<sup>61</sup> Without a meaningful concept of profit,<sup>62</sup> the Soviet economy produced notorious inefficiencies.<sup>63</sup> Profitable enterprises were required to turn over their proceeds to the state, while losing enterprises were guaranteed subsidies as long as they continued to meet their production quotas.<sup>64</sup> By ignoring the profit criterion and evaluating performance in terms of gross output, the system punished altruistic production and rewarded the wanton consumption of supplies.<sup>65</sup> Much of the central administrative system existed to suppress the hoarding and underproduction that resulted from the skewed incentives created by the system of price controls.<sup>66</sup>

In the fall of 1990, President Gorbachev issued a decree that ordered the removal of price controls for certain firms at the production level, while leaving intact the price controls at the retail level.<sup>67</sup> Analysis of this decree reveals that it is not a genuine reform of pricing regulations which will lead to the creation of markets, but rather a half-measure which will likely increase the distortion that currently exists in

<sup>59</sup> The function of currency on the production level was limited to the tasks of state cost accounting. ZWASS, *supra* note 56, at 4. The government used currency and prices because they were the most convenient tool for accounting and control. LINDSAY, *supra* note 55, at 193. In some areas of the economy, individual enterprises could meet required levels of output without possessing any money at all. ZWASS, *supra* note 56, at 4.

<sup>60</sup> The official policy has been to maintain constant prices for all goods, with the specific aim of holding down the prices of commodities, such as food and housing. LINDSAY, *supra* note 55, at 102. Although regulation of supply and demand is possible for production enterprises having inputs and outputs specified by a plan, it is not possible to regulate consumer demand for commodities. ZWASS, *supra* note 56, at 16. No laws control the spending of cash funds by private households. *Id.* Demand for consumer goods is high and supplies are generally low. *Id.* at 3. But because price controls keep prices low, price cannot serve an allocative function in the market. The resulting imbalance between demand and supply creates chronic shortages in the consumer market. *Id.* Thus, price controls are in large part responsible for the fact that there are very few commodities of value for sale on the Soviet domestic economy.

<sup>61</sup> STEPHAN, PARADOX OF PERESTROYKA, *supra* note 57, at 8.

<sup>62</sup> *See id.*

<sup>63</sup> Berman, *The Possibilities and Limits of Soviet Economic Reform*, in SOVIET LAW AND ECONOMY 29, 31 (O. Ioffe & M. Janis eds. 1986).

<sup>64</sup> STEPHAN, PARADOX OF PERESTROYKA, *supra* note 57, at 8. These subsidies currently cost the Soviet government 115 billion rubles each year. *Soviet Prices: When the Price Is Wrong*, ECONOMIST, Feb. 2, 1991, at 45 [hereinafter *Soviet Prices*].

<sup>65</sup> STEPHAN, PARADOX OF PERESTROYKA, *supra* note 57, at 13.

<sup>66</sup> *Id.*

<sup>67</sup> Stephan, *Perestroika and Property*, *supra* note 43, at 62.

the Soviet economy.<sup>68</sup> During January 1991, wholesale prices rose by an average of forty-five percent, while retail prices remained fixed.<sup>69</sup> Consequently, state stores are now required to buy dear and sell cheap. In order to remain viable, these stores will have to receive increased subsidies that will add to, and perhaps double, the current subsidy cost of 115 billion rubles.<sup>70</sup> Fixed retail prices will continue to block the flow of market information on consumer demand, and thus prevent the formation of efficient markets.<sup>71</sup> The squeeze placed on retail sellers will only exacerbate the current economic morass of misallocated resources, shortages of consumer goods, and the diversion of goods and services to the black market.<sup>72</sup>

Even though Western investments are expressly exempt from the Soviet system of administratively set prices,<sup>73</sup> price controls interfere with the conduct of business operations because they destroy market information on supply and demand, and thus inhibit the formation of the markets that Western investors need. In addition, price controls make it difficult to assess the economic value of any business endeavor in the Soviet Union because they undermine the ability of the ruble to stand as a reliable store of value.<sup>74</sup> Future price reforms will bring with them inflation and greater uncertainty,<sup>75</sup> but that is the only way that the Soviet Union will move toward a market economy capable of multinational economic integration.

#### 4. THE STATE MONOPOLY ON FOREIGN EXCHANGE

The fundamental principle of maintaining fixed prices independent of market forces made it necessary for the Soviet government to enact a monopoly on foreign exchange.<sup>76</sup> Price controls distort the value

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<sup>68</sup> *Soviet Prices*, *supra* note 64, at 45.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Stephan, *Perestroika and Property*, *supra* note 43, at 71.

<sup>72</sup> *Id.*

<sup>73</sup> Joint Venture Decree, *supra* note 1, at art. 23.

<sup>74</sup> Stephan, *Restructuring of Soviet Commercial Law*, *supra* note 52, at 100.

While the Soviet government has been printing unknown numbers of rubles, price controls have squelched the effects of inflation in the Soviet economy. *Roubles, Roubles*, *ECONOMIST*, June 17, 1989, at 15, 15-16. Even with the current price controls in place, however, inflation in state stores increases twenty percent per year, and more than fifty percent annually on free markets. *Soviet Prices*, *supra* note 64, at 45.

<sup>75</sup> See *infra* notes 177-81 and accompanying text (discussing relational contracts).

<sup>76</sup> On Transactions in Negotiable Valuables and on Payments in Foreign Currency, 1937 *Sobranie Zakonov i Rasporiazhenii Raboche-Krestyanskogo Pravitelstva S.S.S.R.* No. 8, item 25, (Decree of the Central Executive Committee and USSR Council of People's Commissars of Jan. 7, 1937), *translated in BUSINESS TRANSACTIONS WITH THE U.S.S.R.* 443 (R. Starr ed. 1975).

of products in the Soviet economy and thus destroy any economic parameters that would facilitate a meaningful comparison of Soviet prices with world prices.<sup>77</sup> By creating a system of exchange controls, the Soviet government has designed artificial parameters for measuring the value of exchanges across currencies.

The Soviet government maintains different official rates of exchange for different types of currency transactions.<sup>78</sup> For trade and investment transactions, the rate is 1.8 rubles to the dollar.<sup>79</sup> It is understood that this rate of exchange is not based upon the actual value of the ruble.<sup>80</sup> It is possible, however, to estimate the value of the ruble by examining the average rate of exchange on the black market. On the black market, a dollar trades at twenty or thirty times the official rate of exchange.<sup>81</sup> Western investors thus pay a high premium to convert their hard currency into rubles at the official rate of exchange.

##### 5. TRANSLATION EXPOSURE: HOW THE LAWS ON INVESTMENT INCORPORATE THE OFFICIAL RATE OF EXCHANGE TO REDUCE THE VALUE OF THE WESTERN PARTNER'S CAPITAL CONTRIBUTION

The Soviets desire Western investment for a variety of economic reasons.<sup>82</sup> Nevertheless, they have only grudgingly surrendered economic control to foreigners.<sup>83</sup> The Joint Venture Decree still contains a provision that evidences the Soviet desire to keep economic control in

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<sup>77</sup> Zwass, *supra* note 56, at 62.

<sup>78</sup> For international statistical comparisons, the official rate is 0.6 rubles to the dollar. Keller, *Ruble Profits*, *supra* note 25, at D25, col. 5. Tourists receive six rubles to the dollar. *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> See *Rouble Trouble: Stepping Out*, *ECONOMIST*, Jan. 14, 1989, at 62, 64.

<sup>81</sup> Clines, *Evolution in Europe*, *N.Y. Times*, Oct. 18, 1990, at A14, col. 4. Each day, the ruble's value decreases as goods and supplies are diverted away from state stores to deregulated markets. *Id.*

<sup>82</sup> The Joint Venture Decree states the Soviet Union's desire to increase productivity, to attract foreign technology and expertise, to expand the export sector, and to reduce superfluous imports. Joint Venture Decree, *supra* note 1, at art. 3.

<sup>83</sup> As originally enacted, the Joint Venture Decree limited foreign equity to only forty-nine percent and required that the chairman of the board be a Soviet citizen. Joint Venture Decree, *supra* note 1, at arts. 5, 21. However, Soviet citizenship is no longer a requirement for the chairman of the board. On the Further Development of Foreign Economic Activities of State, Cooperative, and Other Public Enterprises, Associations and Organizations, 1989 SP SSSR No. 2, item 7, at art. 31 (Decree of the USSR Council of Ministers of Dec. 2, 1988), *translated in* HOBER, *supra* note 1, at app. 5 [hereinafter Development of Foreign Economic Activities Decree]. Moreover, foreigners may now own 100 percent of some business concerns. Decree of the USSR President on Foreign Investments in the USSR, *published in* *Izvestiya*, Oct. 26, 1990, at art. 2, *translated in* Federal News Service, Oct. 26, 1990 (LEXIS, NEXIS library, Wires file) [hereinafter Foreign Investment Decree].

Soviet hands. The Joint Venture Decree incorporates the official rate of exchange into its valuation provision to insulate the Soviet partner from a naked comparison with the value of Western capital. The Regulation on Joint-Stock Companies also uses the official rate of exchange in its valuation provision. Both of these provisions present difficult issues of valuation that must be negotiated in the initial proceedings.<sup>84</sup>

### *5.1. Reducing Translation Exposure: Negotiating Around the Valuation Provision in the Joint Venture Decree*

Article 12 of the Joint Venture Decree requires the USSR Ministry of Finance<sup>85</sup> to measure the capital contribution of the Western partner at the official state rate of exchange. It provides that "[t]he contribution of the foreign participant shall be valued . . . [with] the value of the contribution being converted into rubles according to the official exchange rate of the State Bank of the USSR on the date of signing . . . ."<sup>86</sup> Because the official state rate of exchange is artificially low, article 12 operates to give Western partners less than their actual share of equity in the joint venture. Article 31 of the Joint Venture Decree provides that "[t]he profit of a joint enterprise . . . shall be distributed between the participants thereof in proportion to their share participation in the charter fund."<sup>87</sup> Together, these provisions subject foreign investors to a form of translation exposure that reduces their fair share of equity, control, and profit share.

The extent to which these provisions unfairly reduce the value of the Western partner's capital contribution depends upon the actual value of the ruble. Perhaps the best way to assign a value to the ruble is by comparing the official rate of exchange with the rates of exchange on the black market and at previous hard currency auctions. The black market rate of exchange is between twenty and thirty times higher than

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<sup>84</sup> See HOBBER, *supra* note 1, at IX.F(1).

<sup>85</sup> As of November 1990, the process of registration approval was transferred from the USSR level down to the level of the Union and Autonomous Republics. Law on the Fundamentals of Economic Relations between the USSR and the Union and Autonomous Republics, 1990 Ved. Verkh. Sov. SSSR No. 16, item 270 (Law of the USSR, Apr. 10, 1990), *translated in* USSR LEGAL MATERIALS, *supra* note 45. However, the Joint Venture Decree is USSR legislation, and thus remains binding on the Republics. Joint Venture Decree, *supra* note 1, at art. 2.

<sup>86</sup> Joint Venture Decree, *supra* note 1, at art. 12.

It is important to note that none of the valuation procedures actually require the joint venture to convert hard currency contributions into rubles. The authorized fund procedures merely measure the contributions of the respective parties at the official state rate of exchange for the purpose of assigning their respective shares of equity.

<sup>87</sup> *Id.* at art. 31.

the official commercial rate of exchange,<sup>88</sup> while the currency auction rate is approximately fifteen times the commercial rate of exchange.<sup>89</sup> Consequently, where the Western partner's capital contribution is valued at the official rate of exchange, a Soviet partner need only contribute about one-twentieth or five percent of the capital in order to receive a fifty percent ownership interest. Western partners have the burden to present evidence of the unfairness of this process and to negotiate for fair valuation of their equity contribution.<sup>90</sup>

Creativity is the key to successfully negotiating fair valuation of the Western capital contribution. The type of negotiating strategy chosen will depend upon the type of capital structure that the Western investor desires. Although current Soviet economic laws place heavy licensing requirements on thinly capitalized brokerages,<sup>91</sup> it is still possible to establish a company with this capital structure. Western investors can use to their advantage the fact that thinly capitalized brokerages do not require a large pool of operating capital.<sup>92</sup> The object is to contribute intangibles, such as intellectual property or management expertise, and present evidence of their value on world markets. Then, by showing that the official rate of exchange is approximately twenty times higher than the actual value of the ruble, Western investors can obtain fair valuation.

The same strategy should succeed when Western investors contribute hard currency or capital assets. Any discrepancy in the valuation which disadvantages the Western partner can be corrected by negotiating the inclusion of a provision in the charter to pay exorbitant compensation to the Western partner. It may also be possible to correct the

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<sup>88</sup> Clines, *supra* note 81, at A14, col. 4.

<sup>89</sup> See Keller, *Ruble Profits*, *supra* note 25, at D25, col. 5.

<sup>90</sup> According to the assistant general counsel to Data General, Soviet negotiators are willing to compromise and account for Soviet hard currency shortages and the inconvertibility of the ruble. U.S. Business Officials Express Optimism, Concern About U.S.-Soviet Joint-Ventures, 6 Int'l Trade Rep. (BNA) 1385 (Oct. 25, 1989).

<sup>91</sup> In the first two years following the enactment of the Joint Venture Decree, many enterprises were organized as thinly capitalized brokerages. Hertzfeld, *supra* note 4, at 86. These joint ventures purchased Soviet products for rubles and exported them for hard currency. However, the Soviets have severely curtailed this form of operation by enacting a regulation that allows joint ventures to export only the goods which they themselves have produced. Regulation of Foreign Economic Activities, *supra* note 33, at art. 8. In order to establish a joint venture as a brokerage, several licenses must be obtained from the Ministry of Foreign Economic Relations. HOBBER, *supra* note 1, at VI.E(9).

<sup>92</sup> The Ministry of Finance has imposed a *de facto* minimum capitalization requirement of 100,000 rubles for joint ventures. Telephone interview with Adam Deery, White & Case (Dec. 31, 1990). The minimum capitalization requirement for joint-stock companies is 500,000 rubles. Regulation on Joint-Stock Companies, *supra* note 2, at art. 30.

discrepancy by having the Western partner contribute one-third of the capital initially, with the remainder to be contributed within the three-year limit provided by the Joint Venture Decree. Then the investors can enter into a collateral agreement<sup>93</sup> whereby the Soviet partner agrees to waive the remaining obligation when it becomes due.<sup>94</sup>

For at least the next several years, the companies most likely to succeed will be those that are capitalized for production.<sup>95</sup> Because few capital assets can be purchased with rubles,<sup>96</sup> this type of investment will require hard currency capital contributions. Again, Western partners should argue for a better rate of exchange. However, if the rate used for valuation is unsatisfactory, Western partners may achieve a fair allocation of equity and control by convincing the Soviet partners to reduce the value of their contribution. Under this scenario, the Soviet partners would contribute most of their capital in the form of long term, non-interest bearing subordinated debt.<sup>97</sup> This thirty-year debt would possess all of the attributes of equity except that it would not count toward the percentage of ownership.

Where these strategies are impracticable, the Western partner should negotiate directly with the Soviet government for a more accurate rate of exchange in the valuation proceedings.<sup>98</sup> Clearly, it would be in the interest of the Soviet government to exempt such a venture from the operation of the valuation provision in article 12 of the Joint Venture Decree. Without such an exemption, the parties are unlikely to undertake the joint venture.

<sup>93</sup> The Ministry of Finance never sees this type of agreement, and therefore, no official approval is necessary. Paul Harter, Gibson, Dunn & Crutcher, Lecture on Soviet Capitalist Business Transactions at the University of Virginia (Apr. 21, 1989) [hereinafter Harter Lecture].

<sup>94</sup> Little risk is involved in this scenario because the Development of Foreign Economic Activities Decree provides that "the principal issues of the joint enterprise's operation are decided at board meetings *by consensus*." Development of Foreign Economic Activities Decree, *supra* note 83, at art. 31 (emphasis added). Thus, Western partners can always veto the requirement that they fulfill their obligation.

<sup>95</sup> Hertzfeld, *supra* note 4, at 80.

<sup>96</sup> *Risk Rises in USSR, but Also Potential Reward: How Will Developers Respond?*, 1 E. Eur. Construction 5, 5-6 (1991) [hereinafter *Risk Rises in USSR*].

<sup>97</sup> Harter Lecture, *supra* note 94.

<sup>98</sup> See generally Fabri, *Stability of Contractual Relations in Long-Term Transnational Agreements*, 1987 AUSTL. MINING & PETROLEUM L.Y.B. 563 (discussing the feasibility of direct negotiation with the national government for a more accurate rate of exchange).

This form of contract between a transnational corporation and the Soviet government has apparently never been signed. Lack of publicity does not mean, however, that it has never occurred, since secrecy would benefit all parties involved. Telephone interview with Adam Deery, White & Case (Mar. 19, 1990).

## 5.2. *A More Flexible Position on Valuation in the New Regulations on Joint-Stock Companies and Limited Liability Partnerships*

Recently, the Council of Ministers issued new regulations contemplating a more liberal form of investment in a decree entitled Regulations on Joint Stock Companies and Limited Liability Partnerships.<sup>99</sup> Some experts believe that this decree, if successfully implemented, may diminish the importance of prior joint venture legislation.<sup>100</sup> For now, however, and probably for the next few years, the joint venture form will remain the only practical means of direct investment in the Soviet Union.

The main problem with the joint stock company form is a lack of supporting legal infrastructure.<sup>101</sup> For example, joint-stock companies require stock issues, but no stock market presently exists in the Soviet Union.<sup>102</sup> Before the joint stock company form will be feasible, the Soviet Union will have to develop banking regulations, antitrust laws, bankruptcy laws, and laws on credit and collateral.<sup>103</sup>

When investment in a joint-stock company becomes feasible, investors who choose this form of investment will find a valuation provision similar to article 12 of the Joint Venture Decree. However, it is unlikely that the provision will cause as many problems during the initial negotiations. Article 16 of the Regulation on Joint-Stock Companies provides that "[t]he participant's contribution, valued in Soviet rubles, constitutes his share of the charter capital."<sup>104</sup> However, article 20 states, "[d]istribution to participants of net profit . . . shall be made . . . in proportion to the participants' percentage-shares in the charter capital of the company or shares of stock held by them, *or according to whatever methods are provided by the foundation documents.*" (emphasis added)<sup>105</sup> Under this provision, the Regulation on Joint-Stock Companies allows for flexibility in the distribution of profits, regardless of each participant's share of the authorized fund. The Regulation on Joint-Stock Companies also permits the partners to assign control of

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<sup>99</sup> Regulation on Joint-Stock Companies, *supra* note 2.

<sup>100</sup> Stephan, *Restructuring of Soviet Commercial Law*, *supra* note 52, at 91.

<sup>101</sup> See Stephan, *Restructuring of Soviet Commercial Law*, *supra* note 52, at 91 (stating that details concerning the Regulation of Joint-Stock Companies remain sparse).

<sup>102</sup> Although a Soviet stock exchange was officially founded in Moscow on November 12, 1990, there has been no announcement when trading will begin. *New Moscow Stock Exchange Is Country's First Since 1917*, Washington Post, Nov. 14, 1990, at A20, col.5.

<sup>103</sup> See Stephan, *Restructuring of Soviet Commercial Law*, *supra* note 52, at 92.

<sup>104</sup> Regulation on Joint-Stock Companies, *supra* note 2, at art. 16.

<sup>105</sup> *Id.* at art. 20 (emphasis added).

the company in any manner that they desire. Article 4(a) states, "[p]articipants of a company have the right to participate in the management of the affairs of the company in accordance with the foundation documents."<sup>106</sup> Nevertheless, article 16 of the Regulation on Joint-Stock Companies is significant because a Soviet court is likely to interpret the law literally should a dispute regarding ownership or control arise. Thus, Western partners should be careful during the initial negotiations to ensure that the agreed value of the capital contributions is clear.

### 5.3. 100 Percent Foreign Ownership

Pursuant to a recent decree by Soviet President Mikhail Gorbachev, it is now possible for Western investors to avoid the problem of comparing capital contributions by investing in a wholly owned subsidiary.<sup>107</sup> By electing this form, Western investors would escape questions of valuation and would attain complete control over business decisions. However, some serious drawbacks exist. Presently, economic circumstances in the Soviet Union place a premium on political influence and personal connections. Without a Soviet partner, a foreign concern will have difficulty obtaining essential supplies and gaining access to land.<sup>108</sup> Consequently, until the present distribution system is dismantled, it will be better to invest with a Soviet partner who has a personal interest in the enterprise.<sup>109</sup>

## 6. THE PROBLEMS OF EARNING HARD CURRENCY TO FINANCE GROWTH IN THE SOVIET ECONOMY

The primary attraction of direct investment in the Soviet Union is access to a market comprised of more than 280 million people who have been starved of consumer goods.<sup>110</sup> In order to reach this market, investors must establish a vertically integrated company that is capable of expanding its own markets within the Soviet economy.<sup>111</sup> The trouble is that financing growth in the Soviet economy requires hard currency,<sup>112</sup> and there is very little hard currency in the Soviet Union. The

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<sup>106</sup> *Id.* at art. 4.

<sup>107</sup> Foreign Investment Decree, *supra* note 83. Gorbachev declared that "[i]nvestors (legal entities and private citizens) may create on USSR territory enterprises wherein foreign investments account for 100 percent of their assets." *Id.*

<sup>108</sup> Telephone interview with Adam Deery, White & Case (Dec. 31, 1990).

<sup>109</sup> *Id.*

<sup>110</sup> HOBES, *supra* note 1, at IX.G(1).

<sup>111</sup> Hertzfeld, *supra* note 4, at 81.

<sup>112</sup> *Id.* at 89. See *Risk Rises in USSR*, *supra* note 97, at 6.



key to a successful investment strategy will be to secure the hard currency necessary for expansion, without relying upon periodic infusions of new investment capital from the West. A firm can already earn hard currency by engaging in export transactions or by negotiating domestic hard currency transactions. Soon joint ventures may be able to earn some hard currency at public auctions. Unfortunately, all of these avenues are limited by the present constraints of the Soviet economic system.

### 6.1. *Export Transactions*

Absolute control over foreign trade remained in the hands of the Soviet state from the late 1920s until late 1986.<sup>113</sup> Through a series of decrees enacted between 1986 and 1989, the government broke up its monopoly on foreign trade.<sup>114</sup> However, the actions taken by the government over the last few years have revealed a trend toward reinstating bureaucratic control over foreign trade.

The Soviet government has always recognized the need to allow joint ventures to engage in export operations independent of the state monopoly on foreign trade. Article 24 of the Joint Venture Decree provides, "[a] joint enterprise shall be granted the right to conduct export and import operations independently which are necessary for its economic activities . . . ."<sup>115</sup> Export licenses were always required,<sup>116</sup> but for more than two years after the Joint Venture Decree was enacted, the government granted joint ventures relative autonomy in their import and export operations.<sup>117</sup> Export autonomy encouraged the formation of joint ventures that were organized as brokers and intermediaries for export transactions.<sup>118</sup>

In late 1988, the movement toward free trade reached its peak. With the enactment of the Development of Foreign Economic Activities decree, the Council of Ministers proclaimed, "[as of] April 1, 1989, the right to directly perform export-import operations is guaranteed to all enterprises, associations, production cooperatives and other organizations whose products (works, services) are competitive on foreign mar-

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<sup>113</sup> Stephan, *Restructuring of Soviet Commercial Law*, *supra* note 52, at 90.

<sup>114</sup> *Id.* at 91.

<sup>115</sup> Joint Venture Decree, *supra* note 1, at art. 24.

<sup>116</sup> Article 24 of the Joint Venture Decree provides that "[t]he import to the USSR and export from the USSR by a joint enterprise of goods and other property shall be on the basis of authorizations issued in the procedure established by USSR legislation." *Id.* at art. 24.

<sup>117</sup> See HOBER, *supra* note 1, at VI.E(9).

<sup>118</sup> See *id.*

kets."<sup>119</sup> Under this Decree, there emerged a proliferation of Soviet organizations, cooperatives in particular, whose primary business was to broker export transactions.<sup>120</sup> Unfortunately, export transactions began to deplete levels of consumer goods and raw materials which were already in short supply. As shortages became critical, the Council of Ministers adopted a resolution that banned certain exports entirely and placed heavy customs duties on others.<sup>121</sup> The resolution banned the export of "colour and black-and-white television sets, household refrigerators and freezers, washing and sewing machines, clothing and footwear for children, natural and instant coffee, [and] sturgeon and salmon caviar."<sup>122</sup> Additionally, the resolution placed 20 to 100 percent customs duties on certain household goods, such as "vacuum cleaners, mixers, coffee-grinders, irons, household radio-electronic equipment, photo cameras, car spares and accessories."<sup>123</sup>

On March 7, 1989, the USSR Council of Ministers issued the Decree on the Regulation of Foreign Economic Activities which pronounced a new general rule that "[j]oint ventures, international corporations and organizations set up at the Soviet territory are allowed to export only their own products (works, services) . . . ."<sup>124</sup> Joint venture agreements concluded after March 7, 1989 must now have the permission of the USSR Ministry of Foreign Economic Relations in order to carry out intermediary operations.

The Regulations for Operation Licensing in the Foreign Economic Relations of the USSR quickly followed.<sup>125</sup> They authorized the promulgation of a list of goods of national importance which could only be exported under licenses issued from the Soviet ministry that controls the particular good, the Union Republic Council of Ministers, and the USSR Ministry of Foreign Economic Relations.<sup>126</sup> This list includes crude oil, petroleum products, coal, ore, precious metals, ammonia, synthetic rubber, timber, cement, cotton, grain, fish (excluding sturgeon),

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<sup>119</sup> Development of Foreign Economic Activities Decree, *supra* note 83, at art. 2.

<sup>120</sup> HOBER, *supra* note 1, at VI.E(9).

<sup>121</sup> On Additional Measures to Regulate Exports from the USSR of Certain Consumer Goods, 1989 SP SSSR No. 4, item 13 (Decision of the USSR Council of Ministers of Dec. 28, 1988), *translated in* Telegraph Agency of the Soviet Union (TASS), Jan. 1, 1989 (LEXIS, NEXIS library, Wires file).

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> Regulation of Foreign Economic Activities, *supra* note 33, at art. 8.

<sup>125</sup> Regulations for Operation Licensing in the Foreign Economic Relations of the USSR, 1989 Biulleten Normativnykh Aktov Ministerstv i Vedomstv SSSR No. 9, at 25 (Decree of the State Foreign Economic Commission of the USSR Council of Ministers of Mar. 20, 1989), *translated in* USSR LEGAL MATERIALS (V. Pechota & P. Pettibone eds. 1990) [hereinafter Regulations for Operation Licensing].

<sup>126</sup> *Id.* at arts. 5, 6.

wine, and wild animals.<sup>127</sup> The USSR Ministry of Foreign Economic Relations is authorized to limit the volume of any export transaction involving these goods.<sup>128</sup> Moreover, the USSR Ministry of Foreign Economic Relations can set the price that the joint enterprise must pay for the goods that will be exported.<sup>129</sup> Finally, the Ministry of Foreign Economic Relations reserves the right to introduce "[c]onstraints on export and import . . . for specified periods of time . . . [on] individual products (works, services) . . . when this is dictated by a balance of payments situation, or other economic and political considerations . . ."<sup>130</sup>

The impact of these licensing requirements varies from transaction to transaction, but the net effect is to restrict severely the ability of joint ventures to earn hard currency through the export of countertrade goods or goods not produced by the joint venture itself.<sup>131</sup> Today, joint ventures that rely upon export transactions for hard currency must be resourceful enough to create their own production base in the Soviet economy and manufacture goods of sufficient quality for sale on export markets.

## 6.2. Domestic Hard Currency Transactions

The most limited way for a joint venture to earn hard currency in the Soviet Union is through direct negotiation with a Soviet enterprise. Under the External Economic Activity Measures, joint ventures are permitted to negotiate "with Soviet enterprises and organizations . . . [to] determine the kind of currency to be paid in settlements for the products realized . . ."<sup>132</sup> Under this provision, Soviet entities are entitled to use their hard currency reserves to purchase products from joint ventures.<sup>133</sup> This method of earning hard currency is limited because most of the potential purchasers do not possess hard currency. Recently, however, the Gillette Company has negotiated a joint venture with terms providing for substantial compensation in hard currency.<sup>134</sup> Gillette says it will be paid \$100 million over five years in this venture to

<sup>127</sup> Regulation of Foreign Economic Activities, *supra* note 33, at app. 22(9)-(12).

<sup>128</sup> Regulations for Operation Licensing, *supra* note 128, at art. 6.

<sup>129</sup> *Id.*

<sup>130</sup> Regulation of Foreign Economic Activities, *supra* note 33, at art. 9.

<sup>131</sup> HOBER, *supra* note 1, at VI.E(9).

<sup>132</sup> External Economic Activity Measures, *supra* note 28, at app. 4(6).

<sup>133</sup> Gabrisch & Stankovsky, *Special Forms of East-West Trade*, SOVIET & E. EUR. FOREIGN TRADE, Spring 1989, at 5, 65.

<sup>134</sup> Putka, *Gillette Negotiates Venture with Soviets That Has Provisions for Hard Currency*, Wall St. J., Mar. 5, 1991, at A9, col. 2.  
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produce shaving products.<sup>135</sup> Notably, this agreement has not yet been approved by the Ministry of Finance.<sup>136</sup>

### 6.3. *New Hard Currency Auctions*

By law, the ruble remains an internal currency.<sup>137</sup> Rubles cannot be freely exchanged for hard currency. At one time, joint ventures could repatriate hard currency profits only if they actually generated such profits.<sup>138</sup> Soon it may be possible, however, for all companies, including Western concerns, to take their ruble earnings to special currency auctions and bid on foreign currencies offered for sale by Soviet businesses and the government.<sup>139</sup> Whether or not these auctions will provide a viable means of repatriating profits remains unknown.<sup>140</sup>

Several unresolved aspects of the proposed system of currency auctions must be clarified. The key question concerns the amount of hard currency that will be available for exchange.<sup>141</sup> According to Aleksander Y. Voitenkov, the Deputy Chief of Gosbank's foreign currency department, most of the currency would be offered by Soviet exporting enterprises with United States dollars and German marks on hand.<sup>142</sup> Deputy Voitenkov expressed uncertainty over the state's willingness to contribute some hard currency from its reserves.<sup>143</sup> Western economists agree that without the contribution of hard currency by the government, the rate of exchange would be ridiculously low.<sup>144</sup>

Several factors support this conclusion. First, the Soviet government has already permitted several currency auctions to take place since 1988.<sup>145</sup> At those auctions, only a limited number of bidders were allowed to enter, and still the sales were made at 25 rubles to the dollar.<sup>146</sup> The unlimited number of bidders in the new auctions can only decrease the value of the rubles. Second, joint ventures have been free to negotiate contracts in hard currency with Soviet enterprises since the enactment of the External Economic Activity Measures.<sup>147</sup> Experience

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> Berman & Bustin, *The Soviet System of Foreign Trade*, in BUSINESS TRANSACTIONS WITH THE USSR 27, 55 (R. Starr ed. 1975).

<sup>138</sup> See Joint Venture Decree, *supra* note 1, at art. 32.

<sup>139</sup> See Hard Currency Market Decree, *supra* note 24.

<sup>140</sup> Keller, *Ruble Profits*, *supra* note 25, at D1, col. 6.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at D25, col. 5.

<sup>143</sup> *Id.*

<sup>144</sup> See *id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> See External Economic Activity Measures, *supra* note 28, at app. 4(6).

demonstrates that only the exceptional Soviet enterprise possesses hard currency, and these enterprises have been slow to part with it.<sup>148</sup> If Soviet enterprises are reluctant to part with hard currency for the purchase of goods or supplies made with Western technology by joint ventures, why would they be more likely to part with hard currency for rubles, even lots of rubles, that can only purchase the inferior goods available at Soviet state markets?<sup>149</sup> The only way these auctions will provide a reasonable rate of exchange is if the Soviet government contributes some hard currency from its reserves.

The economic program set forth by President Gorbachev calls for a gradual pace to a convertible ruble.<sup>150</sup> At the moment, the Soviet Union is nearly \$4 billion behind on its hard currency trade payments.<sup>151</sup> Under the present circumstances, it is clear that any currency reforms that would allow free convertibility of the ruble would lead to massive capital flight.<sup>152</sup> Even when the new auctions open, the ruble will only be partially convertible. Restrictions on convertibility are likely to remain for several years, or at least until prices are freed sometime in 1992.

## 7. ECONOMIC EXPOSURE

### 7.1. *Economic Exposure: Increased Production Costs Due to Price Reforms*

The concept of economic exposure seeks to measure the degree to which future cash flows will be affected by changes in the value of currency.<sup>153</sup> As the Soviet Union removes controls on the prices that the government pays to Soviet producers, Soviet producers will be able to demand higher prices for the products that they sell to joint ventures.<sup>154</sup> Thus, every joint venture that purchases inputs in the Soviet Union will be subject to economic exposure as price controls at the production level are eliminated.<sup>155</sup>

Under article 26 of the Joint Venture Decree, a joint venture must transact through a Soviet Foreign Trade Organization (FTO) to obtain

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<sup>148</sup> Copetas, *Perestroika's Yankee Partner*, N.Y. Times, June 11, 1989, § 6 (Magazine), at 20.

<sup>149</sup> Newman, *Beleaguered Bloc: As East Europe Opens to the West, Comecon Seeks a Market Niche*, Wall St. J., Sept. 28, 1989, at A1, col. 1, A18, col. 2.

<sup>150</sup> Keller, *Soviet Economy*, *supra* note 34, at A8, col. 1 (box).

<sup>151</sup> Farnsworth, *President of Soviet Republic Seeks U.S. Business Defects*, N.Y. Times, July 30, 1990, at D12, col. 4.

<sup>152</sup> Keller, *Ruble Profits*, *supra* note 25, at D25, col. 5.

<sup>153</sup> FLEXIBLE EXCHANGE RATES, *supra* note 26, at 29.

<sup>154</sup> Keller, *Boomerang*, *supra* note 35, at A6, col. 1.

<sup>155</sup> *Id.*

inputs.<sup>156</sup> Soviet FTOs are supposed to negotiate contracts for supplies in exchange for rubles or hard currency<sup>157</sup> on the basis of contractual prices that "tak[e] into account world market prices."<sup>158</sup> The purpose of this provision was to prevent joint ventures from benefitting from the subsidized prices at which inputs and raw materials are sold to Soviet enterprises.<sup>159</sup> However, as a practical matter, Soviet FTOs have not always been able to negotiate for world prices. Joint ventures would learn the government procurement prices of inputs in their area and then would offer to pay just above that level. As the government removes procurement price controls and increases payments to Soviet producers, the Soviet FTOs will demand higher prices. In the fall of 1990, McDonald's Moscow-based joint venture experienced a doubling of production costs after the government increased payments to Soviet meat producers.<sup>160</sup> All joint ventures can expect to face similar or even greater increases as price reforms are implemented under President Gorbachev's economic program.<sup>161</sup>

## 7.2. *Advance Notice of Price Reforms and Strategic Behavior on the Part of Soviet Producers; President Gorbachev's Plan to Defeat the "Domino Effect"*

Strategic behavior on the part of Soviet producers is a cause of great concern in President Gorbachev's policy on price reforms. Experience has shown that advance notice of price reforms results in a "domino effect," because producers hold their goods off the market until the increase comes into effect.<sup>162</sup>

Last year, in an attempt to put more meat back on the shelves of state stores, the Soviet government announced, in advance, its decision to pay more generous prices to livestock farms that would contract with the state in 1991.<sup>163</sup> The decision reverberated throughout the economy and produced the opposite of the intended effect.<sup>164</sup> During the first six months after the announced price reforms, the supply of meat to state stores dropped sharply because farmers shirked their state quotas, sav-

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<sup>156</sup> *Id.* at art. 26.

<sup>157</sup> See External Economic Activity Measures, *supra* note 28, at app. 4(6).

<sup>158</sup> Joint Venture Decree, *supra* note 1, at art. 26.

<sup>159</sup> Clement, *Changes in the Soviet Foreign Trade System*, SOVIET & E. EUR. FOREIGN TRADE, Winter 1988-89, at 6, 44.

<sup>160</sup> Keller, *Boomerang*, *supra* note 35, at A6, col. 1.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*

ing their livestock for January 1991, when the prices would increase.<sup>165</sup> Lines at state stores grew and prices in the decontrolled farmers' markets soared.<sup>166</sup>

In order to avoid a food crisis, the state yielded and raised meat prices for all producers, effective October 1, 1990.<sup>167</sup> But the lesson on strategic behavior was not lost on President Gorbachev. In order to overcome the potential for strategic behavior resulting from price reforms, Gorbachev discarded the 500-day crash economic program and adopted a slower and more vague blueprint for decontrolling prices.<sup>168</sup>

In his speech introducing his Economic Program, Mr Gorbachev explained:

The most important thing is in one and one half to two years, maximum, to . . . stabilize the monetary system and to strengthen the ruble, and on this basis to provide control over inflation, control over the liberation of prices, over the creation of conditions for economic incentives, activating the mechanisms of market self-regulation.<sup>169</sup>

### *7.3. Problems in Planning Caused by the Policy of Unannounced Price Reforms: Using Relational Contracts to Reduce Uncertainty*

As price reforms enable Soviet prices to reflect the world market, joint ventures will experience significant increases in costs of production. Joint ventures will also face the uncertainty caused by the policy of unannounced price reforms. For new joint ventures still in the planning stage, this uncertainty will affect negotiations that assign rights and responsibilities in the production process.

Although it is common for the Soviet partner in a joint venture to agree to provide inputs, it is possible for either partner to undertake such an obligation. In structuring the joint venture agreement, partners make capital contributions which align their interests. These capital contributions serve as a bonding arrangement. The inability of either partner to perform affects the interests of the other.<sup>170</sup> Thus, regardless

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.* The increased payments further heightened the already bloated budget deficit to levels estimated in excess of ten percent of the gross national product. *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Excerpts from Gorbachev's Speech*, N.Y. Times, Oct. 20, 1990, at A6, col. 1.

<sup>170</sup> See Scott & Goetz, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1131 (1981). However, it is possible to structure a joint venture in a way where failure to perform the procurement of inputs would constitute default. See MacDonald, *Joint Ventures: Breakdowns and Repairs - Rights Upon Default*, 1983 AUSTL. MINING & Published by Penn Law: Legal Scholarship Repository, 2014

of which partner undertakes the obligation to provide inputs, the output plans of the joint venture must be flexible in order to account for the increased operating cost due to the inflationary effects of price control deregulation. This flexibility can be accomplished by executing a relational contract.<sup>171</sup>

The relational contract anticipates the future implementation of price deregulation and provides for a quantity of output that maximizes the expected value of the exchange at the time of contracting.<sup>172</sup> This result is achieved by structuring the agreement such that the volume of inputs required is keyed to the contingent implementation of the price deregulation. Assuming that the decontrolling of prices will increase the costs of operation, and that a fifty percent probability exists that the deregulation will occur during the life of the contract, quantity E will represent the fixed quantity term that maximizes the expected value of the exchange. *See Figure 1.* However, quantity E will always be the "wrong" level of output. Whenever uncertainty exists, an obligation designed to be optimal on average will tend to be incorrect under the circumstances that ultimately occur.<sup>173</sup>

If the deregulation is implemented, quantity Q1 will be the optimal output, and actual profits will diverge from optimal profits by the cross-hatched area A. If the deregulation is not imposed, optimal profits will exceed actual profits by the shaded area B. The profits foregone in either instance will constitute "error costs".<sup>174</sup> The solution is for the

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PETROLEUM L.Y.B. 209 (discussing possible ways to structure the penalty for default). Briefly, these strategies include: (1) a clause that creates a debt obligation of the defaulter to the extent of the amount to be paid; (2) a dilution clause that reduces the interest of a joint venturer who defaults in payment in accordance with a formula, which is based upon the relative contributions to the joint venture by the defaulting and non-defaulting parties; (3) a compulsory acquisition clause where the non-defaulting parties receive an opportunity to acquire the defaulting party's interest in the joint venture at a price determined by an arbitrator; and (4) a forfeiture clause in which the defaulting party is divested of his interest in the joint venture without compensation. *Id.* at 215-21. Note that in proposals (3) and (4), the remaining equity participants would have to pay for the inputs themselves, and thus, they would not be much better off than they were with their Soviet predecessor. *See also* Chambers, *Joint Ventures: Breakdowns and Repairs - Methods of Structuring a Joint Venture to Deal with a Co-Venturer's Failure to Contribute to Expenditure*, 1983 AUSTL. MINING & PETROLEUM L.Y.B. 233.

<sup>171</sup> "In conventional contracts, the parties generally are able to reduce performance standards to rather specific obligations. By contrast, relational contracts create unique, interdependent relationships, wherein unknown contingencies or the intricacy of the required responses may prevent the specification of precise performance standards." Scott & Goetz, *supra* note 170, at 1092.

<sup>172</sup> *Id.* at 1099.

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*



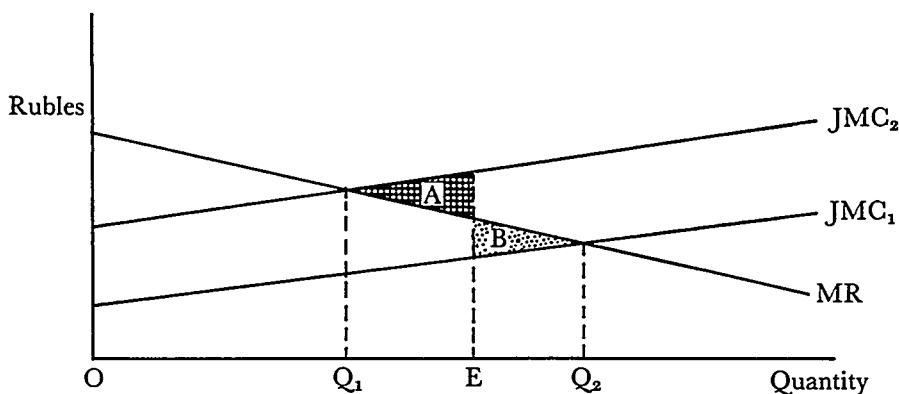


Figure 1

partners to agree to output level  $Q_1$  if prices are decontrolled, and alternatively specify output level  $Q_2$  if no reforms are implemented. In this way, the partners can avoid structuring an agreement which calls for the wrong output.

## 8. CONCLUSION

This article has analyzed some of the ways in which the Soviet economic system interferes with the conduct of business from the perspective of Western investors. Doing business in the Soviet Union is not easy, and will not be easy for some time. Under the current economic system, business transactions are inhibited by Soviet central planning, price controls, exchange controls, and export controls. These elements of the old system suppress free market forces and stifle productivity in the Soviet economy. Until these economic laws are repealed and replaced with a free market system, the decision to invest in the Soviet Union will require a full commitment to establishing a company that is operationally self-sufficient, vertically integrated with reliable Soviet suppliers, and capable of expanding in the Soviet economy without the need for new investment capital from the West.

For now, the current body of restrictive economic laws will remain, not for ideological reasons, but because the current Soviet leadership views them as a means of keeping a lid on political unrest. Ultimately, central political control of the Soviet economy will collapse. However, the collapse of central planning does not mean that the Soviet economy will disintegrate. Even as the power of central leadership diminishes, stability in the management of particular enterprises

grows.<sup>175</sup> Many of the bureaucrats who headed investment negotiations several years ago have themselves joined the joint ventures that they helped envision.<sup>176</sup> These new investments are bringing new information systems, new managerial expertise, new technology, and new investment capital. Together with cooperatives, cities, local governments, and governments at the republic level, these joint ventures will create new arrangements for commerce and production. Those investors who take the initiative will be able to make political connections and to establish ties with consumers that will result in a significant competitive advantage as the Soviet Union creates a new capitalist economy, and moves toward integration with the world economy.

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<sup>175</sup> Hertzfeld, *supra* note 4, at 84.

<sup>176</sup> *Id.*